

Wednesday 17th February 2016

Prudential Regulation Authority
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Dear Sirs,

Article 55 BRRD – bail-in of liabilities arising from obligations under syndicated lending documents

1. Introduction

The Loan Market Association (**LMA**) has as its key objective improving liquidity, efficiency and transparency in the primary and secondary syndicated loan markets in Europe, the Middle East and Africa. The production of recommended documentation is one of the LMA's most important activities and we endeavour to keep our documentation under constant review to ensure that it continues to meet the aims and needs of primary and secondary loan markets.

As part of this documentation review, we have produced a model clause for inclusion in our non-EU law governed template facility agreements to assist our members with compliance with Article 55 of the Bank Recovery and Resolution Directive (**BRRD**).

However, we are concerned that firms are having to include the wording required by Article 55 in documents which create liabilities that are not capable of being bailed-in or where a bail-in of the relevant liabilities would not improve a firm's loss absorbing capacity, because of the breadth of the PRA's interpretation of what would constitute "liabilities" under Article 55. Given the practical difficulties involved in amending existing documentation or negotiating new documentation to include wording of this sort, we are concerned that a broad definition of "liabilities" is not proportionate to achieve the purpose of Article 55.

We would welcome further comment from the PRA on the following points:

- Indicating the types of liabilities that it considers to be within the scope of Article 55;
- Confirming that when supervising compliance with Article 55 the focus of the PRA is on resolvability of the relevant firm;
- Indicating that the PRA would not consider the resolvability of a firm to be affected if Article 55 wording is not included in documentation where the liabilities of the firm are not capable of being quantified at any given time, or where bail in of these liabilities would not improve a firm's loss absorbing capacity, and are consequently not capable of being bailed-in.

If the PRA does not consider that it is able to indicate the types of liabilities that are not within the scope of Article 55, we would welcome further discussion of the types of liabilities where it is "impracticable" for a firm to include Article 55 wording (and confirmation that liabilities of the type discussed in this paper would be such liabilities) and for the PRA to consider granting an extended grace period (of up to 5 years) for inclusion of Article 55 wording into facility agreements executed prior to 1 January 2016.

We would be happy to discuss this further with the PRA or provide any additional information that the PRA may find useful.

2. Need for a proportionate approach to implementation of BRRD

We welcome the PRA's decision to provide clarification on the scope of "liabilities" that it considers to be within the scope of Article 55, particularly since there is no definition of "liabilities" in BRRD itself and since we currently have no guidance from the EBA or the Commission on which liabilities they would consider to be within scope.

However, we are concerned that the PRA has chosen to define "liability" very broadly, and we do not consider that such a broad definition of "liability" is proportionate to achieve the purpose of Article 55. The purpose of Article 55 is to enable resolution authorities to exercise the bail-in power in relation to liabilities governed by the law of a non-EU jurisdiction. However, not all "liabilities" that fall within the PRA definition will be capable of being bailed in or (in the event that they are bailed in) of strengthening the loss absorbing capacity of a firm.

In the context of the syndicated loan markets our concern is that firms are most often party to syndicated lending documentation, not as borrowers, but as credit providers or in some administrative capacity. Obviously, in the rare case that a firm is party to syndicated lending documentation as a borrower, its borrowing liabilities are clearly capable of being bailed in.

However, in the more normal scenario of financial institutions lending to a non-financial institution, the PRA's definition of "liability" will encompass typical obligations undertaken by firms as credit providers and administrative parties in syndicated lending documentation. The types of obligation undertaken by a financial institution in those capacities under syndicated lending documentation are of 5 broad types:

- *Extension of financial accommodation:* for example the obligation to lend or to issue a letter of credit at the borrower's request.
- *Payment conduit:* administrative parties act as a conduit for payments between the borrower and the lenders and hold amounts on trust in certain circumstances, such as on an enforcement of security.
- *Contingent payment obligations:* such as indemnities against losses suffered by administrative parties. In the ordinary course these obligations would be relevant only in the event of default by the borrower.
- *Commercial restrictions:* such as obligations to safeguard the confidentiality of the borrower's information, or an agreement with the other lenders not to take enforcement action in some circumstances.

- *Administrative obligations*: intended to facilitate the smooth running of a multilateral facility, such as requirements to make prescribed notifications and pass information.

We have set out in the Annex to this letter a more detailed indicative list of the types of obligations that a financial institution would typically take on under syndicated lending documentation in those capacities. We would be happy to discuss any of these obligations further with the PRA if that would be useful.

These obligations would typically only give rise to liabilities where the financial institution breaches an obligation, and liabilities arising from breach of these obligations are not capable of being quantified at any given point in time. If a breach of these obligations occurs, the amount of damages that may be payable as a result would not be known (or be reasonably capable of being known) until a judgment is given. As a result, they are unlikely to be capable of being bailed-in.

Even if a claim has been brought in damages for breach of one of these obligations, any judgment given by the courts of a non-EU jurisdiction would not itself include Article 55 wording and would not be affected by the inclusion of Article 55 wording in the underlying contract. As a result, it is unlikely to be possible to exercise write-down or conversion powers to reduce the amount of any judgment debt.

As a result, we do not consider that inclusion of Article 55 wording in syndicated lending documentation would be likely to have an impact on the resolvability of the parties to the documentation.

We would welcome confirmation from the PRA that it intends to take a proportionate approach to implementation of Article 55, and that its primary focus in supervising compliance with Article 55 will be on resolvability. We would also welcome guidance on the factors that are likely to affect any assessment of resolvability, including confirmation that resolvability of a firm is unlikely to be affected by failure to include Article 55 wording in contracts creating liabilities which are not capable of being quantified at any given point in time (such as those which arise in a firm's capacity as a credit provider or administrative party under typical syndicated lending documentation).

If the PRA does not consider it possible to exclude these liabilities from the scope of the rules on contractual recognition of bail-in altogether, we would propose the alternative approach set out below in section 3.

3. Impracticability of including Article 55 wording in pre-existing loan documentation

We welcome the PRA's decision to grant a modification by consent giving firms an additional 6 months to comply with the requirements of Article 55 in cases where it is "impracticable" for them to include Article 55 wording in relevant documents by 1 January 2016. We understand that the PRA intends to consult on a rule change reflecting the modification by consent, and that as part of that consultation the PRA intends to seek further comment on the types of documents which it may be impracticable to amend.

While the LMA has produced a model clause for inclusion in our non-EU law governed template facility agreements, member firms will still need to take steps to incorporate this model clause in their agreements. For new agreements entered into on or after 1 January

2016, this is an additional point to be negotiated between the parties. However, for agreements that were executed prior to 1 January 2016 additional difficulties arise as the documentation has already been negotiated and agreed between all parties, and amending the documents to include Article 55 wording will require the agreement of all parties. In some cases, this could mean that an EU financial institution would need to obtain the agreement of tens or, in some cases hundreds, of other parties in order to amend the documents to include Article 55 wording. This raises difficulties in terms of the timing for obtaining all relevant consents, as well as difficulties in seeking to amend documentation that has previously been agreed between all parties. It is likely that firms will encounter significant commercial resistance to such amendments.

The main situation in which it may be necessary for an EU financial institution to seek to include Article 55 wording in a facility agreement executed prior to 1 January 2016 is where an EU financial institution transfers in as a new lender under the facility agreement. Such a facility agreement will not contain Article 55 wording and when a new lender wants to transfer in they will do so using a standard form of adherence agreement that has already been agreed as part of the suite of original documentation. The facility agreement is not re-negotiated between the parties, and the adherence of a new lender does not present an opportunity for amending the suite of documentation that has already been agreed between the parties.

These difficulties are likely to have a significant negative effect on liquidity in the loan markets and also on the ability of EU financial institutions to manage their risk portfolios (as they will be less able to sell their interests in loans which were in existence prior to 1 January 2016, as where an EU financial institution acquires an interest in the loan this would trigger a requirement to include Article 55 wording in the documentation).

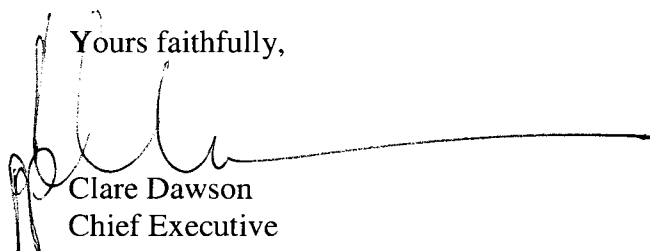
For new agreements entered into on or after 1 January 2016 the parties can include the LMA model clause. However, for existing agreements the only way to insert Article 55 wording is to renegotiate the documentation between all parties.

We consider that it will be impracticable for firms to achieve this and we would welcome discussion of this point in the PRA's consultation paper.

We would also welcome an extended grace period of up to 5 years from 1 January 2016 for compliance with Article 55 in cases where it is impracticable to include Article 55 wording. For the reasons discussed above, we consider that this would be the case in relation to syndicated lending documentation executed prior to 1 January 2016.

We would be pleased to discuss any aspect of the above with you in more detail. If we can be of any further assistance, please do not hesitate to contact me by email at clare.dawson@lma.eu.com or on 020 7006 6007. We would also be pleased to meet to further discuss the above at your convenience.

Yours faithfully,



Clare Dawson
Chief Executive

Annex

Part 1

Typical contractual obligations of financial institutions in syndicated loans

Lenders

1. ***Extension of financial accommodation***

Obligation to lend to borrowers

2. ***Contingent payment obligations***

(a) ***Indemnities***

(i) Indemnity given to facility agent against liability incurred by the facility agent in acting as such

(ii) Counter-indemnity to issuing bank in respect of drawings on a letter of credit which a borrower fails to repay

(b) ***Other payment obligations***

(i) Obligation to provide cash collateral to issuing bank for letter of credit indemnity obligations if downgraded beyond a trigger point

(ii) Obligation to make payments to other lenders to facilitate *pro rata* sharing of recoveries / exposures under the loan among the lending syndicate in certain circumstances

(iii) Obligation to pay tax credits to borrower in certain circumstances

(iv) Obligation to pay any applicable VAT on amounts payable

3. ***Commercial restrictions***

(a) Obligation to keep confidential information relating to the borrower; to notify borrower of breach of confidentiality; and not to use that information for any unlawful purpose

(b) Obligation to consult with the borrower / obtain borrower's consent before transferring lender's participation in the facility

(c) Obligation to transfer its participation in the facility as directed by the borrower in certain circumstances.

(d) Obligation to mitigate circumstances that might lead to a lender making a claim for repayment under illegality protection or indemnification / gross-up under tax or increased costs indemnities provided by borrower

(e) Obligation to cooperate with borrower in making necessary filings under double-taxation treaties

- (f) Obligation not to provide ancillary facilities in excess of lending commitment

4. ***Administrative obligations***

Obligation to notify the facility agent / borrower / other lenders of:

- (a) illegality affecting the lender
- (b) lender's tax position; application of any gross-up obligations; VAT position and information
- (c) amount (and existence) of any claim by the lender under tax, increased costs and break funding indemnities provided by borrower
- (d) secondary debt transactions undertaken by the lender with parties related to the borrower
- (e) ratings downgrade in some circumstances
- (f) information relating to the operation of its ancillary facilities

Facility Agent

1. ***Payment conduit***

Obligation to collect and distribute payments owing from lenders / borrower and distribute to the lenders / borrowers to whom they are due

2. ***Contingent payment obligations***

Obligation to pay any applicable VAT on amounts payable

3. ***Commercial restrictions***

- (a) Obligation to act generally on the instructions of the specified lender group
- (b) Obligation to keep confidential information relating to the borrower; to notify borrower of breach of confidentiality; and not to use that information for any unlawful purpose
- (c) Obligation to keep confidential any quotes given by an institution of its cost of funding the loan; to notify the relevant institution of breach of confidentiality; and not to use that information for any unlawful purpose
- (d) Obligation to enter into negotiations with borrower if loan falls to be priced on the basis of individual lenders' costs of funds

4. ***Administrative obligations***

- (a) Obligation to notify:

- (i) lenders and borrowers of applicable rates of interest
 - (ii) lenders of the borrower's intention to borrow each lenders' participations in that borrowing
 - (iii) lenders of borrower's intention to prepay a facility
 - (iv) borrower of application of provisions requiring a loan to be priced on the basis of individual lenders' cost of funds
 - (v) lenders of specified borrower defaults of which it is aware
 - (vi) borrower and lenders of details of lending syndicate in some circumstances
 - (vii) borrower and lenders upon satisfaction by borrower of conditions precedent to lending
- (b) Obligation to revalue multicurrency drawings on a regular basis by reference to the underlying currency of the facility
 - (c) Obligation to act as a conduit for information / communications between lenders and borrowers (and to notify parties of changes to its contact details)
 - (d) Obligation to bring about transfers of lenders' participations and accession and resignation of borrowers and guarantors by executing otherwise duly executed transfer / accession and resignation documentation
 - (e) Obligation to provide assistance to successor facility agents
 - (f) Obligation to resign as facility agent when requested to do so by specified lender group

Issuing Bank

1. *Extension of financial accommodation*

Obligation to issue letters of credit to counterparties identified by the borrower

2. *Administrative obligations*

- (a) Obligation to notify facility agent and borrower of:
 - (i) any reduction in face value of a letter of credit
 - (ii) expiry of any letter of credit
 - (iii) failure by a lender to provide cash collateral when required to do so
 - (iv) illegality affecting the issuing bank

- (b) Obligation to revalue multicurrency letters of credit on a regular basis by reference to the underlying currency of the facility

Part 2

Typical contractual obligations of financial institutions in intercreditor documentation

Creditors (lenders, hedge counterparties etc)

1. *Contingent payment obligations*

- (a) Obligation to hold any recoveries made from the borrower in certain specified circumstances on trust for (and to pay to) the security agent for distribution by the security agent to creditors in order of priority
- (b) Obligation to return amounts distributed to it by the security agent if original recovery is clawed back.
- (c) Obligation to pay proceeds of any claim against a third party report provider (e.g. law firm due diligence report) to the borrower, or, if the borrower is in distressed circumstances, to the security agent for distribution to creditors in agreed order of priority.
- (d) Obligation to make payments to other creditors of the same ranking to facilitate *pro rata* sharing of recoveries from the borrower among those creditors in certain circumstances
- (e) Indemnity given to security agent against liability incurred by the security agent in acting as such.

2. *Commercial restrictions*

- (a) Obligation to direct any insolvency officer to pay that creditors recoveries against the borrower to security agent for distribution by the security agent to creditors in order of priority
- (b) Obligation to facilitate security agent making insolvency recoveries on the relevant creditor's behalf
- (c) Restriction on exercising any applicable rights of subrogation
- (d) Obligation to vote as directed by security agent in borrower's insolvency / rehabilitation proceedings
- (e) Obligation to facilitate releases / transfers of the relevant creditor's rights against borrower on a restructuring / enforcement
- (f) Restrictions on:
 - (i) amending facility / hedging documentation
 - (ii) receiving or taking further security
 - (iii) taking enforcement action against the borrower
 - (iv) ability to transfer rights and obligations under the document

- (g) Requirement to:
 - (i) Take enforcement action in certain circumstances on the request of other specified creditors
 - (ii) Ensure facility / hedging documentation complies with prescribed terms
 - (iii) Co-operate in ensuring that notional amounts hedged do not exceed a specified limit
 - (iv) Facilitate a refinancing in full of senior lenders (within prescribed limits) by taking necessary actions to give the refinancing lenders equivalent rights to those of the exiting lenders under the transaction security and intercreditor package
- (h) Requirement for senior creditors to transfer their participations in the facility / hedging to junior creditors (on their request) at par when borrower is in distress

3. ***Administrative obligations***

- (i) Obligation to provide information to security agent to facilitate its role as such
- (ii) Requirement to communicate with security agent through any relevant facility agent
- (iii) Obligations to notify:
 - (A) security agent of the extent to which it is able to receive proceeds of enforcement / asset disposal in non-cash format
 - (B) Other creditors and security agent of the occurrence of specified events (e.g. borrower default / distress, taking of enforcement action, waivers of mandatory prepayments, reduction of debt)

Security Agent

1. ***Payment conduit***

- (a) Obligation to hold all amounts received from enforcement of security and / or paid to it by a creditor on trust and distribute to the creditors in the prescribed priority in discharge of amounts owing by the borrower to the creditors
- (b) Obligation to hold the transaction security and resulting proceeds on trust for the creditors

2. ***Commercial restrictions***

- (a) Obligation to act generally on the instructions of the specified lender group and in the interests of a specified lender group in the absence of instructions
- (b) Obligation to enforce security at the times, and in the manner, directed by the specified group of creditors

- (c) Obligation to obtain fair value for the relevant asset when enforcing security or requiring the borrower to make a disposal in distressed circumstances
- (d) Obligation to notify creditors before distributing proceeds of enforcement / asset disposal in non-cash format
- (e) Obligation to hold any non-cash proceeds for any creditor unable to receive non-cash proceeds and deal with those non-cash proceeds on the instructions of that creditor

3. ***Administrative obligations***

- (a) Obligation to notify:
 - (i) creditors of specified borrower defaults of which it is aware
 - (ii) creditors of its spot rate of exchange in some circumstances
- (b) Obligation to act as a conduit for information / communications between creditors and borrower (and to notify parties of changes to its contact details)
- (c) Obligation to bring about accession of creditors and borrowers and guarantors by executing otherwise duly executed accession documentation
- (d) Obligation to provide assistance to successor security agents
- (e) Obligation to resign as security agent when requested to do so by specified creditor group